87-SBE-061

BEFORE THE STATE BOARD OF EQUALIZATION

OF TEE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 85A-42-AJ
TROJAN TOURS, INC.)

Appearances:

For Appellant: Edwin Russ
Certified Public Accountant

Pot Respondent: Lorrie K. fnagaki
Counsel

O P I N I O N

This appeal is made pursuant-to section 25666[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Trojan Tours, Inc., against proposed assessments of additional franchise tax in the amounts of $615, $1,235, and $1,235 for the income years ended November 30, 1980, November 30, 1981, and November 30, 1982, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

The first issue presented is whether appellant is entitled to amortize the claimed cost of a covenant not to compete. If it is entitled, the second issue presented is whether appellant established the cost of the covenant.

Appellant is a California corporation whose principal business activity is the operation of a travel agency. On December 1, 1978, appellant was purchased by Colin and Marcia Kaye Sandell ("Sandells") from Robert D. Maners ("Maners"), appellant's sole shareholder. The sale was structured so that part of Maners' stock was purchased by the Sandells, part was redeemed by the corporation, and part was retained by Maners to be sold to the Sandells at a later date. The sales agreement contained a five-year covenant not to compete, but no part of the purchase price was allocated to the covenant. In 1980, a dispute arose between the Sandells and Maners regarding Maners' representation of the financial condition of the corporation at the time of the sale. As a result of this dispute, a modified sales agreement was executed on June 4, 1980. The sales price was revised, and Maners did not retain any stock. Again, the Sandells purchased a portion of the stock while the corporation redeemed the balance. The modified sales agreement also contained a covenant not to compete, but the term was shortened to three and one-half years, the period remaining on the original covenant. Again, no part of the purchase price was allocated to the covenant. Appellant did not claim any deductions for amortization of the covenant on its franchise tax returns for income years ended November 30, 1978 or 1979. However, it began amortizing the covenant after the modified sales agreement was executed. Appellant assigned the covenant a cost of $45,038 and a useful life of three and one-half years. Maners, on the other hand, did not treat any of the amount he received as being in exchange for his covenant not to compete.

Respondent audited appellant's returns for income years 1980, 1981, and 1982, and determined that appellant was not entitled to amortize the covenant not to compete. It issued proposed assessments reflecting that determination which it affirmed after considering appellant's protest. This timely appeal followed.

California Revenue and Taxation Code section 24349 provides that a depreciation deduction may be taken for the exhaustion, wear and tear, or obsolescence of property used in a trade or business. Section 24349 is

substantially similar to section 167 of the Internal Revenue Code; therefore, federal interpretations of that section are relevant to the proper interpretation of section 24349. An intangible asset is subject to depreciation (amortization) if it is known to be useful in the business or in the production of income for only a limited period, and if the length of that period can be estimated with reasonable accuracy. (Treas. Reg. § 1.167(a)-3.) A covenant not to compete is such an intangible asset and, therefore, consideration paid for the covenant, apart f tom goodwill, may be amortized and yields a deduction to the buyer. (Better Beverages, Inc. v. United States, 619 F.2d 424, 425, fn. 2 (5th Cir. 1980); Appeal of Estate of Joseph J. Gerhart, Deceased, et al., Cal. St. Bd. of Equal., Aug. 18, 1982.) In a transaction where property is sold along with the seller's covenant not to compete, and the parties allocate a portion of the purchase price to the covenant, the allocation will generally be honored for tax purposes and the buyer will be allowed to amortize the amount so allocated and claim deductions over the life of the covenant. (Commissioner v. Gazette Tel. Co., 209 F.2d 926 (10th Cir. 1954).) In cases such as this one, where there is no allocation of any portion of the price to the covenant, the question becomes whether there is evidence. establishing that both parties intended, at the time they entered the agreement, that a portion of the purchase price be assigned to the covenant (Annabelle Candy Co. v. Commissioner, 314 F.2d 1 (9th Cir. 1962).) This determination is a factual one and the taxpayer'bears the burden of proof. (Annabelle Candy Co. v. Commissioner, supra, 314 F.2d at 7).Appellant has produced no evidence indicating that there was mutual intent to allocate part of the purchase price to the covenant and all indications are that there was not. Although the parties negotiated and executed two agreements concerning'the sale of the travel agency, in neither agreement did they allocate part of the purchase price to the covenant. In fact, both agreements specify that the purchase price was given as consideration for the shares of stock in the corporation, and in both agreements, the covenant not to compete is located at the end of the document with no indication that any consideration was given for it. We, therefore, conclude that the parties did not'intend to allocate part of the purchase price to the covenant.

Appellant's arguments focus on the fact that the covenant had value. While that may be true,'that fact alone does not establish that appellant paid any

consideration for it. As the court explained in Annabelle Candy Co. v. Commissioner:

> It is true, as the Tax Court found, that the covenant not to compete played a very real part in the negotiation of a final contract between the parties, and was a valuable benefit to the petitioner. But if the parties did not intend that a part of the purchase price be allocated to this important and valuable covenant, that intention must be respected. Unless respected, the tax consequences which they contemplated as incident to the benefits and burdens of the contract wouid be disturbed.

(Annabelle Candy Co. v. Commissioner, supra, 314 F.2d at 7.)

Appellant mistakenly cites several cases as support for the proposition that a buyer may unilaterally allocate a portion of the purchase price of a business to a covenant without establishing that the parties actually intended to do so. These cases merely apply the well-established principle that the taxing agency can attack an allocation as not reflecting economic reality. (Balthrope v. Commissioner, 356 F.2d 28, 31 (5th Cir. 1966); Schulz v. Commissioner, 294 F.2d 52, 55 (9th Cir. 1961); Forward Communications Corp. v. United States, 608 F.2d 485 (Ct. Cl. 1979).) Although the taxing agency may attack an allocation as being economically unreal, the taxpayer cannot. (See, e.g., Harvey Radio Laboratories, Inc. v. Commissioner, 470 F.2d 118, 120.) To the extent that National Service Industries, Inc. v. United States, 32 A.F.T.R.2d (P-H) ¶ 73-5267 (Ga.D.1973), may indicate otherwise, it fails to persuade this board since it presents no analysis, is contrary to the weight of appellate court authority, and, in any event, is factually distinguishable.

Since appellant has not established that at the time the travel agency was purchased, the parties intended to allocate part of the purchase price to the covenant not to compete, it is not entitled to amortize the covenant. Since we have decided the first issue in favor of respondent, we need not address the valuation issue.

For the reasons discussed above, we must sustain respondent's action.

Appeal of Trojan Tours, Inc.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Trojan Tours, Inc., against proposed assessments of additional franchise tax in the amounts of $615, $1,235, and $1,235 for the income years ended November 30, 1980, November 30, 1981, and November 30, 1982, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 28th day of July, 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9